



الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

Ratings of Institutions offering Islamic Financial Services and Islamic Financial Instruments

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The Islamic International Rating Agency (IIRA) Rates Islamic Banks from three perspectives;

- **Economic, Financial and Investment Quality**
- **Shari'a Compliance**
- **Corporate Governance**



Before we elaborate the above aspects, let us try to highlight some of the differences between Islamic and conventional banks;

- **Profit sharing vs. predetermined interest**
- **Sharing of investment risk vs. guaranteed principal**
- **Legal and Shari'a obligations vs. legal obligations**
- **Ethics and morality vs. profit maximization**
- **Evolving accounting standards vs. defined standards**

These differences play an important role in the rating of an Islamic Bank



Credit Rating

Market Assessment

- **Economic Analysis**
- **Political Regime**
- **Industry analysis**
- **Regulatory environment**
- **Regulators' support for Islamic modes of Financing.**
- **Incentives/ disincentives for Islamic Banking in the economy.**
- **Presence of separate set of rules governing Islamic Financial Institutions and assurance of level playing field for Islamic finance**
- **Accounting Standards**



Asset Quality

- **Credit policies and loan administration**
- **Investment policies**
- **Islamic Characteristics of the products**
- **Portfolio Characteristics**



Risk Management Practices

- **Risk Management practices are evaluated**
- **Risk appetite which should be defined by the board**
- **Allocation of overall risk appetite to the various business and asset categories**
- **Relationship of the risk limits with targeted income**
- **Methods used to evaluate, measure, monitor and control risk**
- **Presence of independent risk control units which have reporting lines distinct from the line managers**



Forecasting a forward looking approach

IIRA rating committee forms an opinion about the likely future asset quality parameter. This is based on

- **The bank's strategic plan and declared future targets for growth and market share**
- **Existing portfolio of the IFI**
- **Portfolios of the competing banks**
- **Loan pricing and status of risk based pricing**
- **Country specific risk factors and risk areas**
- **Future capital plans and cushion available**
- **Existing limits on concentration**



Analytical conclusions regarding economic values

The economic value of asset or liability is the fair market value.

- **Principle of conservatism is adhere to while making such adjustments**
- **Present value of the cash flows associated.**
- **The asset, liability and equity books are adjusted**
- **The bottom line income and earnings are also adjusted**
- **Substance over form Eg. Musharaka and Mudarba investment but treated as loans**



Liquidity and Fund management

- **The ultimate cost of liquidity is to be out of business**
- **Liquidity analysis is performed using combination of ratios and qualitative criteria; focus of the analysis is on**
 - **Structural management of balance sheet**
 - **Funding mix**
 - **Core (inherent) funding level**
 - **Mismatches and additional cost to manage liquidity in times of crisis**
 - **Wholesale vs. retail funding to manage liquidity**
 - **Ability to cope with such handicaps as lack of efficient and Shari'a compliant short term instruments, lender of last resort and salability of loan portfolio in secondary market**



Capital and evaluating capital adequacy

- **Growth of capital- Internal and external**
- **Hidden reserves and unaccounted impairment**
- **Regulatory requirements**
- **Displaced commercial risk- can be accounted for using profiling of assets and liabilities**
- **Adjustment to reflect true economic value**



Earnings

- **The earnings are assessed on the basis of**
- **Predictability and sustainability**
- **Diversification**
- **Earning performance over the years**
- **Efficiency ratios**
- **Adjustment to reflect core earnings**
- **Level of profit distribution to the investment account holder as compared to market returns.**



Management Information Systems

Ability to respond to

- **Customer needs, provides competitive edge to the management and information for control purposes**
- **the requirements of the Islamic Banks such as separation of URIA funds and current account and equity funds and to ascertain return attributable to current account and equity and URIA**
- **Ability of MIS to record the sequence in Murabaha which is critical to Shari'a compliance**
- **The allocation of financial and human resources reveals banks' commitment for IT development**



Reputation & Resources

- **Franchise value of the bank is assessed by degree of market penetration through branch network, brand recognition, pricing power, and loyal customer base**
- **The level and probability of support of other groups & government in times of crisis**
- **IIRA's perception that selective adherence to Shari'a principles can repel or alienate the target customers with long term damaging consequences**



Shari'a Quality Rating

IIRA uses following set of evaluation criteria for assessing the level of Shari'a compliance by IFIs

The Shari'a Committee

- **Existence and constitution**
- **Manner of appointment**
- **Frequency and duration of meetings**
- **Quality and quantity of agenda**
- **Quality of minutes of discussion**
- **Quality of Shari'a committee's relations with management**
- **Distribution/direction of reports of Shari'a committee**
- **Quality of Shari'a committee's relation with general assembly and the Board**
- **Annual Shari'a review report and its importance**



Internal Shari'a Control

- **Existence of approved rules for Shari'a control procedures and operations**
- **Existence of independent department for Shari'a control**
- **Number of Shari'a control staff, their qualification and experience**
- **Distribution of reports**
- **Procedures for dealing with violations and mistakes**
- **Availability of resources for internal Shari'a control**
- **Quality of control based on report examination**

Accounting Standards

- **Adopting AAOIFI standards or any other standards developed in conformity with Islamic financial rules**



Training and Human Resources

- **Existence of training programs in Islamic financial institutions**
- **Quantity and quality of training programs**
- **Number of trainers**
- **The knowledge, experience and training of the staff in Islamic banking**
- **Participation of staff in external training programs**
- **Participation of Shari'a Supervisory Board members in staff training**

Zakat

- **Regularity of Zakat payments**
- **Help given to clients in calculating Zakat**
- **Help given to clients in proper distribution of Zakat**



Social Impact

- **Contribution of financing and investment operations to social aspects such as job creation, economic value creation, etc.**

Modes of Financing

- **Extent of equity participation Ijarah contracts and Mudarabah contracts to total assets**
- **Existence of an approved policy for diversification of financing operations**
- **Sources of funding**

Identity and Corporate Image

- **Existence of approved internal policies to reflect Islamic identity**
- **Corporate image as reflected in publications and marketing activities**



Other Considerations

- **Existence of ladies branches**
- **Gender separation**
- **Existence of approved procedures for purification of non Shari'a compliant income**
- **Existence of prayer rooms**



Corporate Governance Rating

Corporate Governance in Islamic banks is assessed by IIRA using the following set of criteria;

- **Regulatory Compliances**

Level of compliance with all applicable laws, listing requirements and rules of all regulatory, taxation and statutory bodies, including labor and environmental regulations

- **Ownership Structure and behavior**

Structure and breakdown of shareholdings and ownership rights and obligations, dividend policy and support during crisis

- **Board Structure and Processes**

- **Composition, changes, responsibilities, competence in developing strategies, policies, compensation, minority interest, commitment to Sharia guidelines**



- **Executive Management Structure and Processes**
 - **Quality, education, experience, compensation**
 - **Management structure (rigid, flexible, responsive)**
 - **Investment and operational strategies**
 - **Processes for planning, organizing and controlling operations**
- **Transparency**
 - Quality and timeliness of disclosure of adequate information, financial and non financial, compliance with Shari'a guidelines**
 - Disclosure of risk and reward parameters to IAH**
- **Control & Discipline**
 - Qualification and independence of internal and external auditors including Shari'a compliance**
 - Responsibilities and performance of the audit committees**
- **Stakeholders' Relations**
 - Employee-employer relations, human resources management policies and practices and disclosure to code of business conducts and ethics**
 - Entity's social responsibilities and customer relations**



Conclusion

Islamic financial services industry is evolving rapidly, and so are the techniques of rating these institutions. IIRA offers 3 separate rating services for the three aspects discussed in the presentation

Credit Rating

Shari'a Quality Rating

Corporate Governance Rating

While these are distinct approaches, some overlap is bound to occur in analytical process



Thank You

Please visit our website www.iirating.com for information on rating methodologies and rating scales

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